

# **chapter 1**

# **STATEMENT 2 OF CASH FLOWS**

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# Study Objectives

1. Indicate the usefulness of the statement of cash flows.
2. Distinguish among operating, investing, and financing activities.
3. Prepare a statement of cash flows using the indirect method.

# Usefulness and Format

## Usefulness of the Statement of Cash Flows

Provides information to help assess:

1. Entity's ability to generate future cash flows.
2. Entity's ability to pay dividends and obligations.
3. Reasons for difference between net income and net cash provided (used) by operating activities.
4. Cash investing and financing transactions during the period.

# Usefulness and Format

## Classification of Cash Flows

**Operating**  
Activities

Income  
Statement  
Items

**Investing**  
Activities

Changes in  
Investments  
and Long-  
Term Asset  
Items

**Financing**  
Activities

Changes in  
Long-Term  
Liabilities and  
Stockholders'  
Equity

# Usefulness and Format

## Classification of Cash Flows

**Illustration 12-1**  
Typical receipt and  
payment  
classifications

### **Operating activities**—Income statement items

Cash inflows:

- From sale of goods or services.

- From interest received and dividends received.

Cash outflows:

- To suppliers for inventory.

- To employees for services.

- To government for taxes.

- To lenders for interest.

- To others for expenses.

# Usefulness and Format

## Classification of Cash Flows

### Illustration 12-1

Typical receipt and payment classifications

#### **Investing activities**—Changes in investments and long-term assets

Cash inflows:

- From sale of property, plant, and equipment.
- From sale of investments in debt or equity securities of other entities.
- From collection of principal on loans to other entities.

Cash outflows:

- To purchase property, plant, and equipment.
- To purchase investments in debt or equity securities of other entities.
- To make loans to other entities.

#### **Financing activities**—Changes in long-term liabilities and stockholders' equity

Cash inflows:

- From sale of common stock.
- From issuance of debt (bonds and notes).

Cash outflows:

- To stockholders as dividends.
- To redeem long-term debt or reacquire capital stock (treasury stock).



## Accounting Across the Organization

### Net *What*?

Net income is not the same as net cash provided by operations. The differences are illustrated by the following results from recent annual reports (\$ in millions). Note the wide disparity among these companies that all engaged in retail merchandising.

| <b>Company</b>         | <b>Net Income</b> | <b>Net Cash Provided<br/>by Operations</b> |
|------------------------|-------------------|--------------------------------------------|
| Kohl's Corporation     | \$ 1,083          | \$ 1,234                                   |
| Wal-Mart Stores, Inc.  | 11,284            | 20,169                                     |
| JCPenney Company, Inc. | 1,153             | 1,255                                      |
| Costco Wholesale Corp. | 1,082             | 2,076                                      |
| Target Corporation     | 2,849             | 4,125                                      |

**?** In general, why do differences exist between net income and net cash provided by operating activities?

# Usefulness and Format

## Format of the Statement of Cash Flows

### Order of Presentation:

1. Operating activities.
2. Investing activities.
3. Financing activities.

Direct Method

Indirect Method



# Format of the Statement of Cash

## Flows

**Illustration  
12-2**

| <b>COMPANY NAME</b><br>Statement of Cash Flows<br>Period Covered |           |                   |
|------------------------------------------------------------------|-----------|-------------------|
| <b>Cash flows from operating activities</b>                      |           |                   |
| (List of individual items)                                       | <u>XX</u> |                   |
| Net cash provided (used) by operating activities                 |           | XXX               |
| <b>Cash flows from investing activities</b>                      |           |                   |
| (List of individual inflows and outflows)                        | <u>XX</u> |                   |
| Net cash provided (used) by investing activities                 |           | XXX               |
| <b>Cash flows from financing activities</b>                      |           |                   |
| (List of individual inflows and outflows)                        | <u>XX</u> |                   |
| Net cash provided (used) by financing activities                 |           | <u>XXX</u>        |
| <b>Net increase (decrease) in cash</b>                           |           | <u>XXX</u>        |
| <b>Cash at beginning of period</b>                               |           | <u>XXX</u>        |
| <b>Cash at end of period</b>                                     |           | <u><u>XXX</u></u> |
| <b>Non-cash investing and financing activities</b>               |           |                   |

# Format of the Statement of Cash

## Flows

**Illustration:** Classify each of these transactions by type of cash flow activity.

1. Issued 100,000 shares of CU5 par value common stock for CU800,000 cash.
2. Borrowed CU200,000, signing a 5-year note bearing 8% interest.
3. Purchased two semi-trailer trucks for CU170,000 cash.
4. Paid employees CU12,000 for salaries and wages.
5. Collected CU20,000 cash for services provided.

***Do it!***

**Financing**

**Financing**

**Investing**

**Operating**

**Operating**

# Usefulness and Format

## Preparing the Statement of Cash Flows

Three Sources of Information:

1. Comparative balance sheets
2. Current income statement
3. Additional information

# Usefulness and Format

## Preparing the Statement of Cash Flows

### Three Major Steps:

#### Illustration 12-3

Step 1: Determine net cash provided/used by operating activities by converting net income from an accrual basis to a cash basis.



This step involves analyzing not only the current year's income statement but also comparative balance sheets and selected additional data.

# Usefulness and Format

## Preparing the Statement of Cash Flows

Three Major Steps:

**Illustration 12-4**

Step 2: Analyze changes in noncurrent asset and liability accounts and record as investing and financing activities, or disclose as noncash transactions.



This step involves analyzing comparative balance sheet data and selected additional information for their effects on cash.

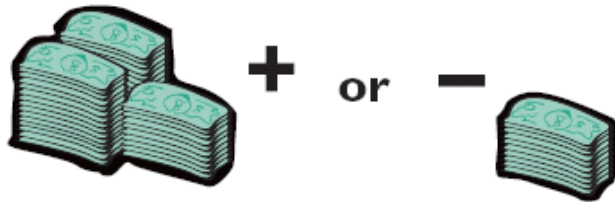
# Usefulness and Format

## Preparing the Statement of Cash Flows

Three Major Steps:

**Illustration 12-5**

Step 3: Compare the net change in cash on the statement of cash flows with the change in the cash account reported on the balance sheet to make sure the amounts agree.



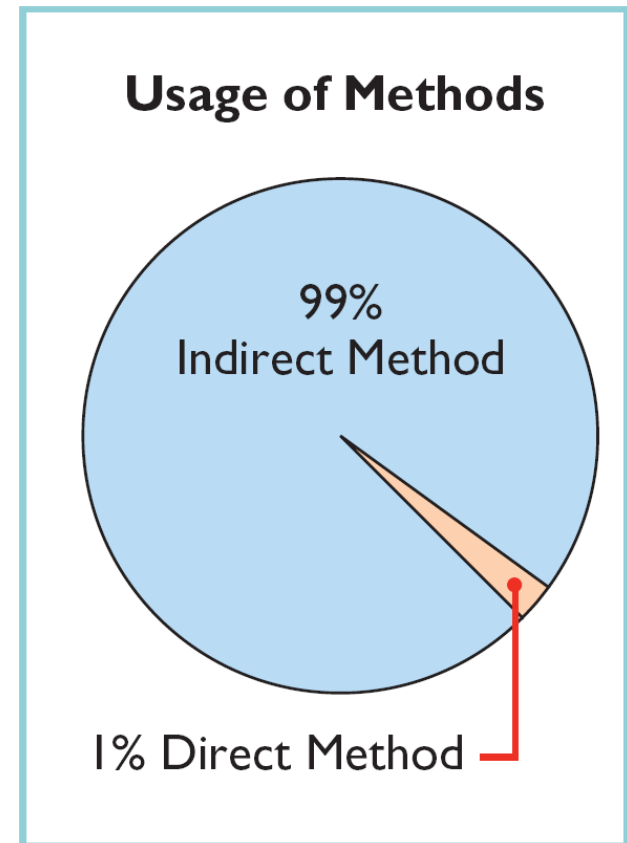
The difference between the beginning and ending cash balances can be easily computed from comparative balance sheets.

# Usefulness and Format

## Indirect and Direct Methods

Companies favor the indirect method for two reasons:

1. Easier and less costly to prepare.
2. Focuses on differences between net income and net cash flow from operating activities.



# Preparing the Statement of Cash

## Flows

### Illustration - Indirect Method

Illustration  
12-6

COMPUTER SERVICES COMPANY  
Income Statement  
For the Year Ended December 31, 2012

|                                             |           |                  |
|---------------------------------------------|-----------|------------------|
| Revenues                                    |           | \$507,000        |
| Cost of goods sold                          | \$150,000 |                  |
| Operating expenses (excluding depreciation) | 111,000   |                  |
| Depreciation expense                        | 9,000     |                  |
| Loss on sale of equipment                   | 3,000     |                  |
| Interest expense                            | 42,000    | 315,000          |
| Income before income tax                    |           | 192,000          |
| Income tax expense                          |           | 47,000           |
| Net income                                  |           | <u>\$145,000</u> |



# Preparing the Statement of Cash

## Flows

### COMPUTER SERVICES COMPANY

Comparative Balance Sheets

December 31

**Illustration  
12-5**

| <u>Assets</u>                      | <u>2012</u>      | <u>2011</u>      | <u>Change in<br/>Account Balance<br/>Increase/Decrease</u> |
|------------------------------------|------------------|------------------|------------------------------------------------------------|
| Current assets                     |                  |                  |                                                            |
| Cash                               | \$ 55,000        | \$ 33,000        | \$ 22,000 Increase                                         |
| Accounts receivable                | 20,000           | 30,000           | 10,000 Decrease                                            |
| Inventory                          | 15,000           | 10,000           | 5,000 Increase                                             |
| Prepaid expenses                   | 5,000            | 1,000            | 4,000 Increase                                             |
| Property, plant, and equipment     |                  |                  |                                                            |
| Land                               | 130,000          | 20,000           | 110,000 Increase                                           |
| Buildings                          | 160,000          | 40,000           | 120,000 Increase                                           |
| Accumulated depreciation—buildings | (11,000)         | (5,000)          | 6,000 Increase                                             |
| Equipment                          | 27,000           | 10,000           | 17,000 Increase                                            |
| Accumulated depreciation—equipment | (3,000)          | (1,000)          | 2,000 Increase                                             |
| Total assets                       | <u>\$398,000</u> | <u>\$138,000</u> |                                                            |

# Preparing the Statement of Cash

## Flows

### Liabilities and Stockholders' Equity

**Illustration  
12-5**

|                                            |                  |                  |           |          |
|--------------------------------------------|------------------|------------------|-----------|----------|
| Current liabilities                        |                  |                  |           |          |
| Accounts payable                           | \$ 28,000        | \$ 12,000        | \$ 16,000 | Increase |
| Income taxes payable                       | 6,000            | 8,000            | 2,000     | Decrease |
| Long-term liabilities                      |                  |                  |           |          |
| Bonds payable                              | 130,000          | 20,000           | 110,000   | Increase |
| Stockholders' equity                       |                  |                  |           |          |
| Common stock                               | 70,000           | 50,000           | 20,000    | Increase |
| Retained earnings                          | 164,000          | 48,000           | 116,000   | Increase |
| Total liabilities and stockholders' equity | <u>\$398,000</u> | <u>\$138,000</u> |           |          |

### **Additional information for 2012:**

1. Depreciation expense was comprised of CU6,000 for building and CU3,000 for equipment.
2. The company sold equipment with a book value of CU7,000 (cost CU8,000, less accumulated depreciation CU1,000) for CU4,000 cash.
3. Issued CU110,000 of long-term bonds in direct exchange for land.
4. A building costing CU120,000 was purchased for cash. Equipment costing CU25,000 was also purchased for cash.
5. Issued common stock for CU20,000 cash.
6. The company declared and paid a CU29,000 cash dividend.

# Preparation of the Statement of Cash Flows – Indirect Method

## Step 1: Operating Activities

Determine net cash provided/used by operating activities by converting net income from accrual basis to cash basis.

### **Common adjustments to Net Income (Loss):**

- ◆ Add back non-cash expenses (depreciation, amortization, or depletion expense).
- ◆ Deduct gains and add losses.
- ◆ Changes in noncash current assets and current liabilities.

# Step 1: Operating Activities

## Question

Which is an example of a cash flow from an operating activity?

- ☒ a. Payment of cash to lenders for interest.
- b. Receipt of cash from the sale of capital stock.
- c. Payment of cash dividends to the company's stockholders.
- d. None of the above.

# Step 1: Operating Activities

## Depreciation Expense

Although depreciation expense reduces net income, it does not reduce cash. The company must add it back to net income.

### Illustration 12-6

#### Cash flows from operating activities:

|                                                                                   |                   |
|-----------------------------------------------------------------------------------|-------------------|
| Net income                                                                        | \$ 145,000        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                   |
| Depreciation expense                                                              | 9,000             |
| Net cash provided by operating activities                                         | <u>\$ 154,000</u> |

# Operating Activities

## Loss on Sale of Equipment

Companies report as a source of cash in the investing activities section the actual amount of cash received from the sale.

- ◆ Any **loss** on sale is **added** to net income in the operating section.
- ◆ Any **gain** on sale is **deducted** from net income in the operating section.

# Operating Activities

## Loss on Sale of Equipment

Illustration 12-7

### Cash flows from operating activities:

|                                                                                      |                   |
|--------------------------------------------------------------------------------------|-------------------|
| Net income                                                                           | \$ 145,000        |
| Adjustments to reconcile net income to net cash<br>provided by operating activities: |                   |
| Depreciation expense                                                                 | 9,000             |
| Loss on sale of equipment                                                            | 3,000             |
| Net cash provided by operating activities                                            | <u>\$ 157,000</u> |

# Operating Activities

## Changes to Noncash Current Asset

### Accounts

When the **Accounts Receivable** balance **decreases**, cash receipts are higher than revenue earned under the accrual basis.

Illustration 12-8

| Accounts Receivable |                 |                |                                |
|---------------------|-----------------|----------------|--------------------------------|
| <b>1/1/012</b>      | <b>Balance</b>  | <b>30,000</b>  | <b>Receipts from customers</b> |
|                     | <b>Revenues</b> | <b>507,000</b> | <b>517,000</b>                 |
| <b>12/31/12</b>     | <b>Balance</b>  |                |                                |
|                     | <b>20,000</b>   |                |                                |

Company adds to net income the amount of the decrease in accounts receivable.



# Operating Activities

## Changes to Noncash Current Asset Accounts

Illustration 12-09

Cash flows from operating activities:

|                                                                                   |                   |
|-----------------------------------------------------------------------------------|-------------------|
| Net income                                                                        | \$ 145,000        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                   |
| Depreciation expense                                                              | 9,000             |
| Loss on sale of equipment                                                         | 3,000             |
| Decrease in accounts receivable                                                   | 10,000            |
| Net cash provided by operating activities                                         | <u>\$ 167,000</u> |

# Operating Activities

## Changes to Noncash Current Asset

### Accounts

When the **Inventory** balance **increases**, the cost of merchandise purchased exceeds the cost of goods sold.

| Inventory |           |         |                            |
|-----------|-----------|---------|----------------------------|
| 1/1/12    | Balance   | 10,000  | Cost of goods sold 150,000 |
|           | Purchases | 155,000 |                            |
| 12/31/12  | Balance   | 15,000  |                            |

Cost of goods sold does not reflect cash payments made for merchandise. The company deducts from net income this inventory increase.

# Operating Activities

## Changes to Noncash Current Asset Accounts

Illustration 12-10

Cash flows from operating activities:

|            |            |
|------------|------------|
| Net income | \$ 145,000 |
|------------|------------|

Adjustments to reconcile net income to net cash  
provided by operating activities:

|                      |       |
|----------------------|-------|
| Depreciation expense | 9,000 |
|----------------------|-------|

|                           |       |
|---------------------------|-------|
| Loss on sale of equipment | 3,000 |
|---------------------------|-------|

|                                 |        |
|---------------------------------|--------|
| Decrease in accounts receivable | 10,000 |
|---------------------------------|--------|

|                              |                |
|------------------------------|----------------|
| <b>Increase in inventory</b> | <b>(5,000)</b> |
|------------------------------|----------------|

|                                           |                   |
|-------------------------------------------|-------------------|
| Net cash provided by operating activities | <u>\$ 162,000</u> |
|-------------------------------------------|-------------------|

# Operating Activities

## Changes to Noncash Current Asset

### Accounts

When the **Prepaid Expense** balance **increases**, cash paid for expenses is higher than expenses reported on an accrual basis. The company **deducts the decrease** from net income to arrive at net cash provided by operating activities.

If **prepaid expenses decrease**, reported expenses are higher than the expenses paid.

# Operating Activities

## Changes to Noncash Current Asset Accounts

Illustration 12-11

### Cash flows from operating activities:

|                                                                                   |                   |
|-----------------------------------------------------------------------------------|-------------------|
| Net income                                                                        | \$ 145,000        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                   |
| Depreciation expense                                                              | 9,000             |
| Loss on sale of equipment                                                         | 3,000             |
| Decrease in accounts receivable                                                   | 10,000            |
| Increase in inventory                                                             | (5,000)           |
| Increase in prepaid expenses                                                      | (4,000)           |
| Net cash provided by operating activities                                         | <u>\$ 158,000</u> |

# Operating Activities

## Changes to Noncash Current Liability

### Accounts

When **Accounts Payable increases**, the company received more in goods than it actually paid for. The **increase is added** to net income to determine net cash provided by operating activities.

When **Income Tax Payable decreases**, the income tax expense reported on the income statement was less than the amount of taxes paid during the period. The **decrease is subtracted** from net income to determine net cash provided by operating activities.

# Operating Activities

## Changes to Noncash Current Liability

### Accounts

Illustration 12-11

Cash flows from operating activities:

|                                                                                   |                   |
|-----------------------------------------------------------------------------------|-------------------|
| Net income                                                                        | \$ 145,000        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                   |
| Depreciation expense                                                              | 9,000             |
| Loss on sale of equipment                                                         | 3,000             |
| Decrease in accounts receivable                                                   | 10,000            |
| Increase in inventory                                                             | (5,000)           |
| Increase in prepaid expenses                                                      | (4,000)           |
| Increase in accounts payable                                                      | 16,000            |
| Decrease in income taxes payable                                                  | (2,000)           |
| Net cash provided by operating activities                                         | <u>\$ 172,000</u> |

# Operating Activities

## Summary of Conversion to Net Cash Provided by Operating Activities—Indirect Method

Illustration 12-12

### Adjustment Required to Convert Net Income to Net Cash Provided by Operating Activities

|                                                   |                                       |        |
|---------------------------------------------------|---------------------------------------|--------|
| Noncash charges                                   | Depreciation expense                  | Add    |
|                                                   | Patent amortization expense           | Add    |
| Gains and losses                                  | Loss on sale of plant asset           | Add    |
|                                                   | Gain on sale of plant asset           | Deduct |
| Changes in current assets and current liabilities | Increase in current asset account     | Deduct |
|                                                   | Decrease in current asset account     | Add    |
|                                                   | Increase in current liability account | Add    |
|                                                   | Decrease in current liability account | Deduct |



## ANATOMY OF A FRAUD

For more than a decade, the top executives at the Italian dairy products company **Parmalat** engaged in multiple frauds which overstated cash and other assets by more than \$1 billion while understating liabilities by between \$8 and \$12 billion. Much of the fraud involved creating fictitious sources and uses of cash. Some of these activities incorporated sophisticated financial transactions with subsidiaries created with the help of large international financial institutions. However, much of the fraud employed very basic, even sloppy, forgery of documents. For example, when outside auditors requested confirmation of bank accounts (such as a fake \$4.8 billion account in the Cayman Islands), documents were created on scanners, with signatures that were cut and pasted from other documents. These were then passed through a fax machine numerous times to make them look real (if difficult to read). Similarly, fictitious bills were created in order to divert funds to other businesses owned by the Tanzi family (who controlled Parmalat).

Total take: Billions of dollars

### THE MISSING CONTROL

## Step 2: Investing and Financing

### Activities

Company purchased **land** of CU110,000 by issuing **long-term bonds**. This is a significant noncash investing and financing activity that merits disclosure in a separate schedule.

| Land     |              |         |  |
|----------|--------------|---------|--|
| 1/1/12   | Balance      | 20,000  |  |
|          | Issued bonds |         |  |
| 110,000  |              |         |  |
| 12/31/12 | Balance      |         |  |
|          |              | 130,000 |  |

| Bonds Payable |          |          |         |
|---------------|----------|----------|---------|
|               | 1/1/12   | Balance  | 20,000  |
|               |          | For land | 110,000 |
|               | 12/31/12 |          | Balance |
|               |          |          | 130,000 |

# Investing and Financing Activities

## Partial statement

Illustration 12-14

|                                           |                         |
|-------------------------------------------|-------------------------|
| Net cash provided by operating activities | <u>172,000</u>          |
| Cash flows from investing activities:     |                         |
| Purchase of building                      | (120,000)               |
| Purchase of equipment                     | (25,000)                |
| Sale of equipment                         | 4,000                   |
| Net cash used by investing activities     | <u>(141,000)</u>        |
| Cash flows from financing activities:     |                         |
| Issuance of common stock                  | 20,000                  |
| Payment of cash dividends                 | (29,000)                |
| Net cash used by financing activities     | <u>(9,000)</u>          |
| Net increase in cash                      | 22,000                  |
| Cash at beginning of period               | 33,000                  |
| Cash at end of period                     | <u><u>\$ 55,000</u></u> |

|                                                |                          |
|------------------------------------------------|--------------------------|
| Disclosure: Issuance of bonds to purchase land | <u><u>\$ 110,000</u></u> |
|------------------------------------------------|--------------------------|

# Investing and Financing Activities

From the additional information, the company acquired an **office building** for CU120,000 cash. This is a cash outflow reported in the investing section.

| Building           |                 |        |
|--------------------|-----------------|--------|
| 1/1/12             | Balance         | 40,000 |
|                    | Office building |        |
| <del>120,000</del> |                 |        |
| 12/31/12           | Balance         |        |
|                    | 160,000         |        |

# Investing and Financing Activities

## Partial statement

Illustration 12-14

|                                                    |                              |
|----------------------------------------------------|------------------------------|
| Net cash provided by operating activities          | <u>172,000</u>               |
| Cash flows from investing activities:              |                              |
| Purchase of building                               | (120,000)                    |
| Purchase of equipment                              | (25,000)                     |
| Sale of equipment                                  | 4,000                        |
| Net cash used by investing activities              | <u>(141,000)</u>             |
| Cash flows from financing activities:              |                              |
| Issuance of common stock                           | 20,000                       |
| Payment of cash dividends                          | (29,000)                     |
| Net cash used by financing activities              | <u>(9,000)</u>               |
| Net increase in cash                               | 22,000                       |
| Cash at beginning of period                        | 33,000                       |
| Cash at end of period                              | <u><u>\$ 55,000</u></u>      |
| <br>Disclosure: Issuance of bonds to purchase land | <br><u><u>\$ 110,000</u></u> |

# Investing and Financing Activities

The additional information explains that the equipment increase resulted from two transactions: (1) a purchase of equipment of CU25,000, and (2) the sale for CU4,000 of equipment costing CU8,000.

| Equipment |          |        |                |       |
|-----------|----------|--------|----------------|-------|
| 1/1/12    | Balance  | 10,000 | Equipment sold | 8,000 |
|           | Purchase | 25,000 |                |       |
| 12/31/12  | Balance  |        |                |       |
|           |          | 27,000 |                |       |

Journal  
Entry

|                           |       |
|---------------------------|-------|
| Cash                      | 4,000 |
| Accumulated depreciation  | 1,000 |
| Loss on sale of equipment | 3,000 |
| Equipment                 | 8,000 |

# Statement of Cash Flows

## Indirect Method

### Illustration 12-14

#### Cash flows from operating activities:

Net income

\$ 145,000

#### Adjustments to reconcile net income to net cash provided by operating activities:

Depreciation expense

9,000

**Loss on sale of equipment**

**3,000**

Decrease in accounts receivable

10,000

Increase in inventory

(5,000)

Increase in prepaid expenses

(4,000)

Increase in accounts payable

16,000

Decrease in income taxes payable

(2,000)

Net cash provided by operating activities

172,000

#### Cash flows from investing activities:

Purchase of building

(120,000)

**Purchase of equipment**

**(25,000)**

**Sale of equipment**

**4,000**

Net cash used by investing activities

(141,000)

#### Cash flows from financing activities:

Issuance of common stock

20,000

Payment of cash dividends

(29,000)

Net cash used by financing activities

(9,000)

Net increase in cash

22,000

Cash at beginning of period

33,000

Cash at end of period

\$ 55,000

# Investing and Financing Activities

The increase in common stock resulted from the issuance of new shares.

| Common Stock |             |        |
|--------------|-------------|--------|
| 1/1/12       | Balance     | 50,000 |
|              | Shares sold | 20,000 |
| 12/31/12     | Balance     |        |
|              |             | 70,000 |



# Investing and Financing Activities

## Partial statement

Illustration 12-14

|                                                    |                              |
|----------------------------------------------------|------------------------------|
| Net cash provided by operating activities          | <u>172,000</u>               |
| Cash flows from investing activities:              |                              |
| Purchase of building                               | (120,000)                    |
| Purchase of equipment                              | (25,000)                     |
| Sale of equipment                                  | 4,000                        |
| Net cash used by investing activities              | <u>(141,000)</u>             |
| Cash flows from financing activities:              |                              |
| <b>Issuance of common stock</b>                    | <b>20,000</b>                |
| Payment of cash dividends                          | (29,000)                     |
| Net cash used by financing activities              | <u>(9,000)</u>               |
| Net increase in cash                               | 22,000                       |
| Cash at beginning of period                        | 33,000                       |
| Cash at end of period                              | <u><u>\$ 55,000</u></u>      |
| <br>Disclosure: Issuance of bonds to purchase land | <br><u><u>\$ 110,000</u></u> |

# Investing and Financing Activities

Retained earnings increased CU116,000 during the year. This increase can be explained by two factors: (1) Net income of CU145,000 increased retained earnings, and (2) Dividends of CU29,000 decreased retained earnings.

| Retained Earnings |        |          |                    |
|-------------------|--------|----------|--------------------|
| Dividends         | 29,000 | 1/1/12   | Balance 48,000     |
|                   |        |          | Net income 145,000 |
|                   |        | 12/31/12 | Balance            |
|                   |        |          | 164,000            |

# Statement of Cash Flows

## Indirect Method

### Illustration 12-14

#### Cash flows from operating activities:

**Net income**

**\$ 145,000**

#### Adjustments to reconcile net income to net cash provided by operating activities:

|                                           |                |
|-------------------------------------------|----------------|
| Depreciation expense                      | 9,000          |
| Loss on sale of equipment                 | 3,000          |
| Decrease in accounts receivable           | 10,000         |
| Increase in inventory                     | (5,000)        |
| Increase in prepaid expenses              | (4,000)        |
| Increase in accounts payable              | 16,000         |
| Decrease in income taxes payable          | (2,000)        |
| Net cash provided by operating activities | <u>172,000</u> |

#### Cash flows from investing activities:

|                                       |                  |
|---------------------------------------|------------------|
| Purchase of building                  | (120,000)        |
| Purchase of equipment                 | (25,000)         |
| Sale of equipment                     | 4,000            |
| Net cash used by investing activities | <u>(141,000)</u> |

#### Cash flows from financing activities:

|                                       |                 |
|---------------------------------------|-----------------|
| Issuance of common stock              | 20,000          |
| <b>Payment of cash dividends</b>      | <b>(29,000)</b> |
| Net cash used by financing activities | <u>(9,000)</u>  |

Net increase in cash

22,000

Cash at beginning of period

33,000

Cash at end of period

\$ 55,000

## **Step 3: Net Change in Cash**

Compare the net change in cash on the Statement of Cash Flows with the change in the cash account reported on the Balance Sheet to make sure the amounts agree.

# Investing and Financing Activities

## Review Question

Which is an example of a cash flow from an investing activity?

- a. Receipt of cash from the issuance of bonds payable.
- b. Payment of cash to repurchase outstanding capital stock.
- c. Receipt of cash from the sale of equipment.
- d. Payment of cash to suppliers for inventory.

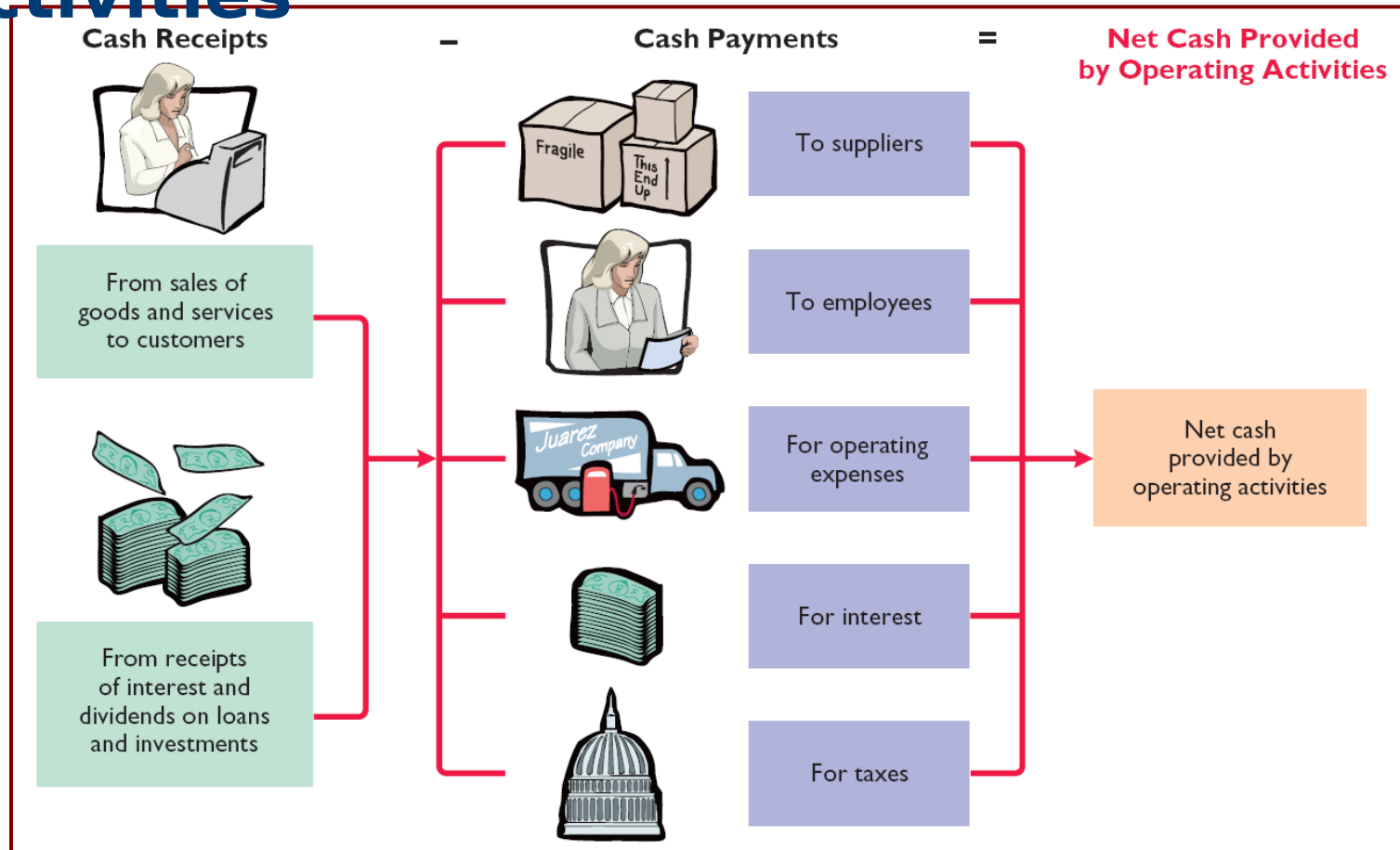
1. Compute net cash provided by operating activities by adjusting each item in the income statement from the accrual basis to the cash basis.
2. Companies report only major classes of operating cash receipts and cash payments.
3. For these major classes, the difference between cash receipts and cash payments is the net cash provided by operating activities.

# appendix 12A

## Direct Method

### Step 1: Operating Activities

Illustration 12A-2



# appendix 12A

## Direct Method

### COMPUTER SERVICES COMPANY Comparative Balance Sheets December 31

#### Illustration 12A-1

| <u>Assets</u>                      | <u>2012</u>      | <u>2011</u>      | <u>Change in<br/>Account Balance<br/>Increase/Decrease</u> |
|------------------------------------|------------------|------------------|------------------------------------------------------------|
| Current assets                     |                  |                  |                                                            |
| Cash                               | \$ 55,000        | \$ 33,000        | \$ 22,000 Increase                                         |
| Accounts receivable                | 20,000           | 30,000           | 10,000 Decrease                                            |
| Inventory                          | 15,000           | 10,000           | 5,000 Increase                                             |
| Prepaid expenses                   | 5,000            | 1,000            | 4,000 Increase                                             |
| Property, plant, and equipment     |                  |                  |                                                            |
| Land                               | 130,000          | 20,000           | 110,000 Increase                                           |
| Buildings                          | 160,000          | 40,000           | 120,000 Increase                                           |
| Accumulated depreciation—buildings | (11,000)         | (5,000)          | 6,000 Increase                                             |
| Equipment                          | 27,000           | 10,000           | 17,000 Increase                                            |
| Accumulated depreciation—equipment | (3,000)          | (1,000)          | 2,000 Increase                                             |
| Total assets                       | <u>\$398,000</u> | <u>\$138,000</u> |                                                            |



# appendix 12A

## Direct Method

### COMPUTER SERVICES COMPANY Comparative Balance Sheets December 31

#### Illustration 12A-1

|                                                    | <u>2012</u>             | <u>2011</u>             | <u>Change in<br/>Account Balance<br/>Increase/Decrease</u> |
|----------------------------------------------------|-------------------------|-------------------------|------------------------------------------------------------|
| <b><u>Liabilities and Stockholders' Equity</u></b> |                         |                         |                                                            |
| Current liabilities                                |                         |                         |                                                            |
| Accounts payable                                   | \$ 28,000               | \$ 12,000               | \$ 16,000 Increase                                         |
| Income taxes payable                               | 6,000                   | 8,000                   | 2,000 Decrease                                             |
| Long-term liabilities                              |                         |                         |                                                            |
| Bonds payable                                      | 130,000                 | 20,000                  | 110,000 Increase                                           |
| Stockholders' equity                               |                         |                         |                                                            |
| Common stock                                       | 70,000                  | 50,000                  | 20,000 Increase                                            |
| Retained earnings                                  | <u>164,000</u>          | <u>48,000</u>           | 116,000 Increase                                           |
| Total liabilities and stockholders' equity         | <u><u>\$398,000</u></u> | <u><u>\$138,000</u></u> |                                                            |

# appendix 12A

## COMPUTER SERVICES COMPANY Income Statement For the Year Ended December 31, 2012

|                                             |               |                         |
|---------------------------------------------|---------------|-------------------------|
| Revenues                                    |               | \$507,000               |
| Cost of goods sold                          | \$150,000     |                         |
| Operating expenses (excluding depreciation) | 111,000       |                         |
| Depreciation expense                        | 9,000         |                         |
| Loss on sale of equipment                   | 3,000         |                         |
| Interest expense                            | <u>42,000</u> | <u>315,000</u>          |
| Income before income tax                    |               | 192,000                 |
| Income tax expense                          |               | <u>47,000</u>           |
| Net income                                  |               | <u><u>\$145,000</u></u> |

### Additional information for 2012:

1. Depreciation expense was comprised of \$6,000 for building and \$3,000 for equipment.
2. The company sold equipment with a book value of \$7,000 (cost \$8,000, less accumulated depreciation \$1,000) for \$4,000 cash.
3. Issued \$110,000 of long-term bonds in direct exchange for land.
4. A building costing \$120,000 was purchased for cash. Equipment costing \$25,000 was also purchased for cash.
5. Issued common stock for \$20,000 cash.
6. The company declared and paid a \$29,000 cash dividend.

# appendix 12A

## Direct Method

### Cash Receipts from Customers

For Computer Services, accounts receivable decreased CU10,000

Illustration 12A-4

| Accounts Receivable |                     |         |                                               |
|---------------------|---------------------|---------|-----------------------------------------------|
| 1/1/12              | Balance             | 30,000  | <b>Receipts from customers</b> <b>517,000</b> |
|                     | Revenues from sales | 507,000 |                                               |
| 12/31/12            | Balance             | 20,000  |                                               |

Illustration 12A-5

|                                             |   |                                    |   |                                                                                       |
|---------------------------------------------|---|------------------------------------|---|---------------------------------------------------------------------------------------|
| <b>Cash Receipts<br/>from<br/>Customers</b> | = | <b>Revenues<br/>from<br/>Sales</b> | { | <b>+ Decrease in Accounts Receivable<br/>or<br/>– Increase in Accounts Receivable</b> |
|---------------------------------------------|---|------------------------------------|---|---------------------------------------------------------------------------------------|

# appendix 12A

## Direct Method

### Cash Payments to Suppliers

In 2012, Computer Services' inventory increased CU5,000.

| Inventory |                  |                |                                   |
|-----------|------------------|----------------|-----------------------------------|
| 1/1/12    | Balance          | 10,000         |                                   |
|           | <b>Purchases</b> | <b>155,000</b> |                                   |
|           |                  |                | <b>Cost of goods sold 150,000</b> |
| 12/31/12  |                  | Balance        |                                   |
|           | 15,000           |                |                                   |

Illustration 12A-

8

| Accounts Payable                     |          |                  |        |
|--------------------------------------|----------|------------------|--------|
| <b>Payments to suppliers 139,000</b> | 1/1/12   | Balance          | 12,000 |
|                                      |          | <b>Purchases</b> |        |
|                                      |          | <b>155,000</b>   |        |
|                                      | 12/31/12 | Balance          | 20,000 |

### Cash Payments to Suppliers

In 2012, Computer Services' inventory increased CU5,000.

Illustration 12A-9

$$\begin{array}{lcl} \text{Cash Payments to Suppliers} & = & \text{Cost of Goods Sold} \left\{ \begin{array}{l} + \text{Increase in Inventory} \\ \text{or} \\ - \text{Decrease in Inventory} \end{array} \right\} \left\{ \begin{array}{l} + \text{Decrease in Accounts Payable} \\ \text{or} \\ - \text{Increase in Accounts Payable} \end{array} \right\} \end{array}$$

### Cash Payments for Operating Expenses

Cash payments for operating expenses were CU111,000.

Illustration 12A-10

|                                             |                                |
|---------------------------------------------|--------------------------------|
| Operating expenses                          | \$ 111,000                     |
| Add: Increase in prepaid expenses           | <u>4,000</u>                   |
| <b>Cash payments for operating expenses</b> | <b><u><u>\$115,000</u></u></b> |

Illustration 12A-11

|                                             |   |                    |                                                                                                                                            |                                                                                                                                                              |
|---------------------------------------------|---|--------------------|--------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Cash Payments for Operating Expenses</b> | = | Operating Expenses | $\left\{ \begin{array}{l} + \text{ Increase in Prepaid Expense} \\ \text{or} \\ - \text{ Decrease in Prepaid Expense} \end{array} \right.$ | $\left\{ \begin{array}{l} + \text{ Decrease in Accrued Expenses Payable} \\ \text{or} \\ - \text{ Increase in Accrued Expenses Payable} \end{array} \right.$ |
|---------------------------------------------|---|--------------------|--------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------|

### Cash Payments for Interest

In 2012, Computer Services' had interest expense of CU42,000.

| Interest Payable                     |                         |
|--------------------------------------|-------------------------|
| <b>Cash paid for interest 42,000</b> | <b>1/1/12 Balance</b>   |
|                                      | <b>Interest expense</b> |
|                                      | <b>42,000</b>           |
|                                      | <b>12/31/12</b>         |
|                                      | <b>Balance</b>          |
|                                      | <b>0</b>                |

# appendix 12A

## Direct Method

### Cash Payments for Income Taxes

Cash payments for income taxes were CU49,000.

| Income Tax                 |               |                           |
|----------------------------|---------------|---------------------------|
| <b>Cash paid for taxes</b> | <b>49,000</b> | <b>1/1/12 Balance</b>     |
|                            |               | <b>Income tax expense</b> |
|                            |               | <b>47,000</b>             |
|                            |               | <b>12/31/10 Balance</b>   |
|                            |               | <b>6,000</b>              |

Illustration 12A-13

$$\begin{array}{l}
 \text{Cash} \\
 \text{Payments for} \\
 \text{Income Taxes}
 \end{array}
 =
 \begin{array}{l}
 \text{Income Tax} \\
 \text{Expense}
 \end{array}
 \left\{
 \begin{array}{l}
 + \text{ Decrease in Income Taxes Payable} \\
 \text{or} \\
 - \text{ Increase in Income Taxes Payable}
 \end{array}
 \right.$$



# appendix 12A

## Direct Method

### Illustration 12A-14

Operating activities section  
of the statement of cash flows

|                                           |           |                |
|-------------------------------------------|-----------|----------------|
| Cash flows from operating activities      |           |                |
| Cash receipts from customers              |           | \$517,000      |
| Less: Cash payments:                      |           |                |
| To suppliers                              | \$139,000 |                |
| For operating expenses                    | 115,000   |                |
| For interest expense                      | 42,000    |                |
| For income taxes                          | 49,000    | <u>345,000</u> |
| Net cash provided by operating activities |           | \$172,000      |

# appendix 12A

## Direct Method

### Step 2: Investing and Financing Activities

**Increase in Equipment.** (1) Equipment purchased for CU25,000, and (2) sale for CU4,000 of equipment CU8,000.

Illustration 12A-15

| Equipment                           |        |                        |       |
|-------------------------------------|--------|------------------------|-------|
| 1/1/10 Balance                      | 10,000 | Cost of equipment sold | 8,000 |
| <b>Purchase of equipment 25,000</b> |        |                        |       |
| 12/31/10 Balance                    | 27,000 |                        |       |

| Accumulated Depreciation |              |                      |       |
|--------------------------|--------------|----------------------|-------|
| <b>Equipment sold</b>    | <b>1,000</b> | 1/1/12 Balance       |       |
|                          |              | Depreciation expense | 3,000 |
|                          |              | 12/31/12 Balance     | 3,000 |

### Step 2: Investing and Financing Activities

**Increase in Equipment.** (1) Equipment purchased for CU25,000, and (2) sale for CU4,000 of equipment CU8,000.

|                           |       |
|---------------------------|-------|
| Cash                      | 4,000 |
| Accumulated depreciation  | 1,000 |
| Loss on sale of equipment | 3,000 |
| Equipment                 | 8,000 |

### Step 2: Investing and Financing Activities

**Increase in Land.** Land increased CU110,000. The additional information section indicates that the company exchanged bonds for land.

**Increase in Building.** Acquired building for CU120,000 cash.

**Increase in Bonds Payable.** Bonds Payable increased CU110,000. The company acquired land by exchanging bonds for land.

Significant noncash  
investing and  
financing  
transaction.

Investing  
transaction.

Significant noncash  
investing and  
financing  
transaction.

## Step 2: Investing and Financing Activities

### **Increase in Common Stock.**

Increase in Common Stock of CU20,000. Increase resulted from the issuance of new shares of stock.

Financing  
transaction.

### **Increase in Retained Earnings.**

The CU116,000 net increase in Retained Earnings resulted from net income of CU145,000 and the declaration and payment of a cash dividend of CU29,000.

Financing  
transaction (cash  
dividend).

# appendix 12A

## Direct Method

### Step 2: Investing and Financing Activities

#### Illustration 12A-16

Statement of cash flows, 2012—direct method

12-62

| COMPUTER SERVICES COMPANY<br>Statement of Cash Flows—Direct Method<br>For the Year Ended December 31, 2012 |            |  |                   |
|------------------------------------------------------------------------------------------------------------|------------|--|-------------------|
| Cash flows from operating activities                                                                       |            |  |                   |
| Cash receipts from customers                                                                               |            |  | \$ 517,000        |
| Less: Cash payments:                                                                                       |            |  |                   |
| To suppliers                                                                                               | \$ 139,000 |  |                   |
| For operating expenses                                                                                     | 115,000    |  |                   |
| For income taxes                                                                                           | 49,000     |  |                   |
| For interest expense                                                                                       | 42,000     |  |                   |
|                                                                                                            |            |  | <u>345,000</u>    |
| Net cash provided by operating activities                                                                  |            |  | 172,000           |
| Cash flows from investing activities                                                                       |            |  |                   |
| Sale of equipment                                                                                          | 4,000      |  |                   |
| Purchase of building                                                                                       | (120,000)  |  |                   |
| Purchase of equipment                                                                                      | (25,000)   |  |                   |
|                                                                                                            |            |  | <u>(141,000)</u>  |
| Net cash used by investing activities                                                                      |            |  | (141,000)         |
| Cash flows from financing activities                                                                       |            |  |                   |
| Issuance of common stock                                                                                   | 20,000     |  |                   |
| Payment of cash dividends                                                                                  | (29,000)   |  |                   |
|                                                                                                            |            |  | <u>(9,000)</u>    |
| Net cash used by financing activities                                                                      |            |  | (9,000)           |
| Net increase in cash                                                                                       |            |  | 22,000            |
| Cash at beginning of period                                                                                |            |  | 33,000            |
| Cash at end of period                                                                                      |            |  | <u>\$ 55,000</u>  |
| Noncash investing and financing activities                                                                 |            |  |                   |
| Issuance of bonds payable to purchase land                                                                 |            |  | <u>\$ 110,000</u> |



# IFRS

## A Look at IFRS

### Key Points

- ◆ **The definition of cash equivalents used in IFRS is similar to that used in GAAP. A major difference is that in certain situations, bank overdrafts are considered part of cash and cash equivalents under IFRS (which is not the case in GAAP). Under GAAP, bank overdrafts are classified as financing activities in the statement of cash flows and are reported as liabilities on the balance sheet.**



# IFRS

## A Look at IFRS

### Key Points

- ◆ **One area where there can be substantial differences between IFRS and GAAP relates to the classification of interest, dividends, and taxes. The following table indicates the differences between the two approaches**

| <u>Item</u>        | <u>IFRS</u>                                                                   | <u>GAAP</u> |
|--------------------|-------------------------------------------------------------------------------|-------------|
| Interest paid      | Operating or financing                                                        | Operating   |
| Interest received  | Operating or investing                                                        | Operating   |
| Dividends paid     | Operating or financing                                                        | Financing   |
| Dividends received | Operating or investing                                                        | Operating   |
| Taxes paid         | Operating—unless specific identification with financing or investing activity | Operating   |





**IFRS**

**A Look at IFRS**

**Under IFRS, interest paid can be reported as:**

**a) only a financing element.**

**b) a financing element or an investing  
○ element.**

**c) a financing element or an operating  
element.**

**d) only an operating element.**



**IFRS**

**A Look at IFRS**

**IFRS requires that noncash items:**

- a) be reported in the section to which they relate, that is, a noncash investing activity would be reported in the investing section.**
- b) be disclosed in the notes to the financial statements.**
- c) do not need to be reported.**
- d) be treated in a fashion similar to cash equivalents.**



**IFRS**

**A Look at IFRS**

**In the future, it appears likely that:**

- a) the income statement and balance sheet will have headings of operating, investing, and financing, much like the statement of cash flows.**
- b) cash and cash equivalents will be combined in a single line item.**
- c) the IASB will not allow companies to use the direct approach to the statement of cash flows.**